

APPENDIX IV

TAX ACCOUNTING EXAMPLE (REFER RESPONSE TO AMENDMENT PROPOSAL A2.1)

MOOMBA-ADELAIDE PIPELINE

Tax Accounting Example

Epic has adopted conventional accounting practice in its accounting for tax. It records in its profit and loss statement the tax that would have been payable if it had been taxed (at the statutory rate) on its pre-tax accounting income. The tax that would have been payable – the tax expense – is different from the tax actually paid because pre-tax accounting income usually differs to taxable income. The principal reason for the difference is the acceleration of depreciation for income tax purposes.

In years in which the depreciation calculated for accounting purposes is less than the depreciation calculated for the purpose of determining taxable income, (resulting in pre-tax accounting income being higher than taxable income), the tax effect of the depreciation difference, (the difference in depreciation multiplied by the statutory tax rate), is added to a deferred tax liability account. In years in which depreciation calculated for accounting purposes is greater than the depreciation calculated for the purpose of determining taxable income, (resulting in pre-tax accounting income being less than taxable income), the tax effect of the depreciation difference is deducted from the deferred tax liability account.

The deferred tax liability, along with any Future Income Tax Benefits, provides a reconciliation of the year-by-year differences between (accounting) tax expense and the cash tax liability due to the Australian Taxation Office.

As such, the deferred tax liability has no direct impact on cash flows. The deferred tax liability does not, as the Commission asserts on page 35 of the Draft Decision, have the effect of reducing future cash flows by reducing future tax payments. The tax paid is the tax to be paid in accordance with the Tax Act, irrespective of any balance reported in the deferred tax liability account. There is no effect on future value to be addressed through a reduction in the value of the physical assets of the continuing business.

The Commission seems to have reasonably reflected the tax to be paid by Epic– the actual cash flow – in its cash flow modelling. However, Epic considers that the Commission is flawed in its argument to reduce the Initial Capital Base by subtracting from the asset valuation an amount derived from an account which has, as its only purpose, the reconciliation of the notional tax expenses reported in the profit and loss statement with the actual cash liability for payments of tax.

A simplified example (in a format similar to the Commission's model) that shows why Epic considers it is incorrect to adjust the Initial Capital Base for the deferred tax liability recorded in the accounts is set out in the tables which follow (see attached). The example is based on the assumption that the business owns one income-producing, depreciable asset.

As shown in the example, the deferred tax liability is a reconciliation of the difference between the tax expense and tax payable (tax loss). The total tax expenses recorded in the accounts over the accounting life of the asset equals the total of the tax actually paid over that period.

The example clearly shows that, depending on the period in which the Commission assesses the tariff to be charged, the deferred tax liability used to reduce the initial capital base will differ significantly. For example, in year 2 the deferred tax liability is \$9.0, however in year 4 it is \$18.0 and in year 7 it is \$9.0 again. Depending on the point in the cycle of the life of its depreciable assets in which the company is operating, the permanent adjustment to the initial capital base by the Commission in a tariff decision would have a significant impact on future revenues, which is clearly inappropriate.

The Commission has argued, on page 37 of the Draft Decision, that adjusting the initial capital base for the deferred tax liability notionally “refunds” those customers who, under the prior tariff regime, paid tariffs with a tax component in excess of that required by Epic to meet its actual tax liabilities.

No evidence is presented in the Draft Decision to support the contention that MAPS users paid tariffs that included a higher tax component than should have been the case. Indeed, it is difficult to see how such evidence could have been provided. The current tariffs for MAPS evolved from the tariffs which applied when the Pipeline was owned by the Government of South Australia, and were not the subject of explicit determination by Epic. If they had been the subject of explicit determination, they were not likely to have included a component “to cover normal or prima facie taxes”. The current tariffs apply only until 2005, and during the period 1995-2005 Epic does not expect to pay tax in respect of the MAPS.

The tariffs paid by current users were not regulated, but the outcomes of negotiations with those users as part of MAPS privatisation in 1995. Commercially negotiated tariffs between unrelated parties will not “match” the tariff outcomes of a particular theoretical model as the Commission seems to imply. Even if those tariffs are higher than the tariffs that result from application of a particular model after the event, this does not imply that one component – the allowance for tax – was higher than it should have been, and does not imply that, were there an excess, the excess is a recovery of capital. All that can be concluded is that, overall, the tariffs were higher, reflecting the outcomes of negotiation.

It is simply incorrect for the Commission to argue that Epic has made excess returns during 1995 to 2000 because of flawed tax assumptions used in determining its current tariffs, when no such assumptions were made and the tariffs were determined during a process of freely conducted negotiations.

Furthermore, it is incorrect to argue, as the Commission has done, that the deferred tax liability reported by Epic Energy South Australia in some way reflects the perceived excess return obtained during 1995 to 2000. Deferred tax, as stated above, is simply an accounting concept. As a result, the idea of offsetting the deferred tax liability against the initial capital base to take account of this perceived excess return has no justification.

Accordingly, Epic strongly considers that the initial capital base of the MAPS should not be reduced by the deferred tax liability reported by Epic Energy South Australia.

The Commission’s reduction of the initial capital base by the deferred tax liability is an inconsistency in the use of an approach which is of serious concern to Epic. In assessing proposed reference tariffs, the Commission has based its analysis on an “ideal” pipeline entity. Its view of the initial capital base is based on the “ideal” of a DORC valuation. Its assumptions about the valuation of imputation credits, and about capital structure, are based on an “ideal” entity, and not “standard industry structures for a going concern and best practice”. Having approached tariff determination from the point of view of an “ideal” pipeline entity, the Commission then proceeds to make arbitrary adjustments to the “ideal”. In proceeding in this way and, in particular, in making these arbitrary adjustments, the Commission makes no attempt to justify its actions in terms of the obligations imposed on it as a regulator under the *National Third Party Access Code for Natural Gas Pipeline Systems*. This is a matter on which Epic will continue to address its concerns.

On the issue of the Commission’s treatment of taxation generally, Epic makes the following additional comments.

The Commission has assumed in its modelling that Epic will continue to receive the full benefit of its carry forward tax losses. The *Income Tax Assessment Act (both 1936 and*

1997) as amended (ITAA) imposes onerous obligations on companies in relation to the ability to carry forward and offset tax losses against future assessable income.

Epic requests confirmation that the Commission will take into account in any future, calculation of the tariff any actual change to the company's tax loss position.

The Australian Government has proposed various tax changes as part of its Business Tax Reform (BTR). Some of these proposals have already been implemented, and some will have effect from 1 July 2001. The BTR initiatives will have a serious impact on the taxation treatment of Epic. In addition to more onerous carry forward loss provisions, the prospect of consolidation of group companies from 1 July 2001 may also impact on the losses available to any one company.

Epic request that the Commission confirm that the impact of the BTR changes will be reflected in future tariff determinations.

Appendix IV

Moomba-Adelaide Pipeline

Tax accounting example

Year	1	2	3	4	5	6	7	8	9	10
Tax effect accounting										
Revenue	24.4	24.2	24.0	23.8	23.5	23.3	23.0	23.3	24.7	24.3
Expenses										
Return on debt	4.4	4.1	3.7	3.4	3.0	2.5	2.1	1.6	1.1	0.6
Depreciation	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Non-capital costs	7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5
Pre-tax accounting income	2.5	2.6	2.8	2.9	3.1	3.2	3.4	4.2	6.1	6.2
Tax expense	0.7	0.8	0.8	0.9	0.9	1.0	1.0	1.3	1.8	1.9
Post-tax accounting income	1.7	1.8	2.0	2.1	2.2	2.3	2.4	3.0	4.2	4.3
Tax expense	0.7	0.8	0.8	0.9	0.9	1.0	1.0	1.3	1.8	1.9
Tax expense (cumulative)	0.7	1.5	2.4	3.3	4.2	5.1	6.2	7.4	9.2	11.1
Tax payable	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.4	4.8	4.9
Tax payable (cumulative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.4	6.2	11.1
Tax expense (cumulative) - Tax payable (cumulative)	0.7	1.5	2.4	3.3	4.2	5.1	6.2	6.0	3.0	0.0
Tax loss at corporate tax rate	-3.8	-7.5	-11.1	-14.7	-10.8	-6.9	-2.8	0.0	0.0	0.0
Depreciation difference (accounting - tax)	-15.0	-15.0	-15.0	-15.0	10.0	10.0	10.0	10.0	10.0	10.0
Tax effect of depreciation difference (deferred tax liability)	-4.5	-4.5	-4.5	-4.5	3.0	3.0	3.0	3.0	3.0	3.0
Deferred tax liability (cumulative)	-4.5	-9.0	-13.5	-18.0	-15.0	-12.0	-9.0	-6.0	-3.0	0.0
Proof	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Appendix IV

Moomba-Adelaide Pipeline

Tax accounting example

Year		1	2	3	4	5	6	7	8	9	10
Inputs											
Pipeline											
Initial asset value	100 \$m										
Economic life	10 years										
Life for tax depreciation	4 years										
Corporate tax rate	30.00%										
Approximate effective tax rate	7.87%										
Inflation and cost of capital											
Real risk free rate	2.97%										
Nominal risk free rate	6.10%										
Market risk premium	6.00%										
Usage of imputation credits	50.00%										
Debt margin	1.20%										
Debt beta	0.06										
Capital structure: D/V	60.00%										
Asset beta	0.50										
Non-capital costs	\$m	7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5

Appendix IV

Moomba-Adelaide Pipeline

Tax accounting example

Year		1	2	3	4	5	6	7	8	9	10
Regulatory asset accounting											
Expected inflation	3.04%										
Initial asset value	100 \$m										
Asset life (remaining)	10 years										
Inflated asset values											
Opening asset value	\$m	103.0	95.6	87.5	78.9	69.7	59.8	49.3	38.1	26.2	13.5
Depreciation		10.3	10.6	10.9	11.3	11.6	12.0	12.3	12.7	13.1	13.5
Closing asset value		92.7	84.9	76.6	67.6	58.1	47.9	37.0	25.4	13.1	0.0
Nominal asset values											
Opening asset value	\$m	103.0	95.6	87.5	78.9	69.7	59.8	49.3	38.1	26.2	13.5
Nominal depreciation		7.3	7.8	8.4	8.9	9.6	10.2	10.9	11.6	12.3	13.1
Closing asset value		92.7	84.9	76.6	67.6	58.1	47.9	37.0	25.4	13.1	0.0
Real asset values											
Opening asset value	\$m	100.0	90.0	80.0	70.0	60.0	50.0	40.0	30.0	20.0	10.0
Depreciation		10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Closing asset value		90.0	80.0	70.0	60.0	50.0	40.0	30.0	20.0	10.0	0.0

Appendix IV

Moomba-Adelaide Pipeline

Tax accounting example

<u>Year</u>		<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>10</u>
Tax asset accounting											
Opening asset value	\$m	100.0	75.0	50.0	25.0	0.0	0.0	0.0	0.0	0.0	0.0
Depreciation		25.0	25.0	25.0	25.0	0.0	0.0	0.0	0.0	0.0	0.0
Closing asset value		75.0	50.0	25.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Appendix IV

Moomba-Adelaide Pipeline

Tax accounting example

Year 1 2 3 4 5 6 7 8 9 10

Cost of capital

Expected inflation 3.04%

Return on debt 7.30%

Return on equity

Nominal risk free rate 6.10%

Equity beta 1.16

Market risk premium 6.00%

Return on equity 13.04%

Appendix IV

Moomba-Adelaide Pipeline

Tax accounting example

Year		1	2	3	4	5	6	7	8	9	10
Required revenue											
Regulatory asset base (opening)											
Real	\$m	100.0	90.0	80.0	70.0	60.0	50.0	40.0	30.0	20.0	10.0
Nominal		100.0	92.7	84.9	76.6	67.6	58.1	47.9	37.0	25.4	13.1
Equity	\$m	40.0	37.1	34.0	30.6	27.1	23.2	19.1	14.8	10.2	5.2
Debt		60.0	55.6	51.0	45.9	40.6	34.8	28.7	22.2	15.2	7.9
Required revenue											
Return on assets											
Return on equity	\$m	5.2	4.8	4.4	4.0	3.5	3.0	2.5	1.9	1.3	0.7
Return on debt		4.4	4.1	3.7	3.4	3.0	2.5	2.1	1.6	1.1	0.6
Nominal depreciation	\$m	7.3	7.8	8.4	8.9	9.6	10.2	10.9	11.6	12.3	13.1
Non-capital costs		7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5
Tax payable		0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.4	4.8	4.9
Less: value of imputation credits		0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.7	-2.4	-2.4
Required revenue	\$m	24.4	24.2	24.0	23.8	23.5	23.3	23.0	23.3	24.7	24.3

Appendix IV

Moomba-Adelaide Pipeline

Tax accounting example

Year	1	2	3	4	5	6	7	8	9	10
Tax calculations										
Income	24.4	24.2	24.0	23.8	23.5	23.3	23.0	23.3	24.7	24.3
Tax expenses										
Return on debt	4.4	4.1	3.7	3.4	3.0	2.5	2.1	1.6	1.1	0.6
Tax depreciation	25.0	25.0	25.0	25.0	0.0	0.0	0.0	0.0	0.0	0.0
Non-capital costs	7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5
	\$m									
Taxable income	-12.5	-12.4	-12.2	-12.1	13.1	13.2	13.4	14.2	16.1	16.2
Tax loss brought forward	\$m									
Taxable payable	0.0	-12.5	-24.9	-37.1	-49.2	-36.1	-22.8	-9.5	0.0	0.0
Tax loss carried forward		0.0	0.0	0.0	0.0	0.0	0.0	1.4	4.8	4.9
		-12.5	-24.9	-37.1	-49.2	-36.1	-22.8	-9.5	0.0	0.0
Tax payable difference (Set to zero using Macro 1)	0.0 \$m	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Value of imputation credits		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.7	2.4

Appendix IV

Moomba-Adelaide Pipeline

Tax accounting example

Year		1	2	3	4	5	6	7	8	9	10
Nominal cash flow analysis											
Capex	100										
Return on debt		4.4	4.1	3.7	3.4	3.0	2.5	2.1	1.6	1.1	0.6
Repayment of debt	-60.0	4.4	4.7	5.0	5.4	5.7	6.1	6.5	6.9	7.4	7.9
Nominal cash flow to equity holders											
Pre-tax	-40.0	8.1	8.0	7.8	7.6	7.4	7.1	6.8	7.3	8.7	8.3
Post-tax	-40.0	8.1	8.0	7.8	7.6	7.4	7.1	6.8	5.8	3.8	3.5
Post-tax + value of imputation credits	-40.0	8.1	8.0	7.8	7.6	7.4	7.1	6.8	6.6	6.3	5.9
Internal rates of return											
Pre-tax	14.15%										
Post-tax	11.78%										
Post-tax + value of imputation credits	13.04%										
Effective tax rate	7.87%										